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IN THE

Supreme Court of the United States

OCTOBER TERM 1925.

THE UNITED STATES,
Petitioner,
vs.
CHARLES A. LUDEY.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE RESPONDENT IN OPPOSITION

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Citations.

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Opinion Below.

The opinion of the Court of Claims (R., 14) has not yet been officially reported.

Jurisdiction.

The judgment to be reviewed was entered November 9, 1925 (R., 20). Jurisdiction of this Court to issue the writ is conferred by Section 3 (b) of the Act of February 13, 1925, Chap. 229, 43 Stat. 936, 939.

The Question Involved.

In determining the gain or loss of the owner or lessee upon the sale of capital assets under the tax laws, should depletion sustained or previously allowed for oil extracted and/or depreciation sustained or previously allowed be subtracted from the cost price or added to the sales price in determining gain or loss upon sale in 1917?

Statement of the Case.

The details are unimportant in the consideration of this matter on petition for writ of certiorari. The essential facts are that the Respondent purchased and sold certain leaseholds and fees to lands which contained oil. Between the date of purchase and the date of sale, these properties were operated and so-called depletion sustained. The Respondent, in calculating his net income subject to tax for the calendar year 1917, compared the cost of these properties with the sales price thereof and found that he had suffered a loss on the sale which he accordingly claimed. The Commissioner in auditing the taxpayer's return for 1917, rejected the method used by the Respondent in determining his net income and while purporting to reduce the cost by the amount of depletion and depreciation sustained, the Commissioner in reality added to the sales price the amount of the depletion and depreciation sustained, thereby fictitiously inflating the sales price. The Commissioner in this manner determined that the Respondent had made a gain on the sale, although the amount received from the sale of the properties was less than the amount he had paid for them. The Court of Claims held that the Commissioner's action in connection with these adjustments in regard to so-called depletion and depreciation on the sale of the fees and leaseholds in 1917 was erroneous.

The Statutes.

Title I, Act of September 8, 1916 (Chap. 463, 39 Stat. 56), as amended by the Act of October 3, 1917 (Chap. 3, 40 Stat. 300, 329), provides:

> Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *
>
> (b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax), there shall be levied, assessed, collected, and paid upon total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds $20,000 and does not exceed $40,000 * * *
>
> (c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.
>
> Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or

profit, or gains or profits and income derived from any source whatever * * *

* * * * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: Provided, That *for the purpose of ascertaining the loss sustained from the sale or other disposition of property*, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *

Sec. 1. War Income Tax (Chap. 63, 40 Stat. 300),—That in addition to the normal tax imposed by subdivision (a) of section one of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per

centum upon the income of every individual, a citizen or resident of the United States, received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the income of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:

One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *.

Title II, Act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *.

ARGUMENT.

Issue II set forth in the Government's petition has previously been decided by this Court.

In the Government's statement of the issues, contained in the petition for writ of certiorari, the second issue is stated (R. 4) as follows:

> II. Where property is acquired prior to March 1, 1913, and the sale price is greater than the cost but less than the March 1, 1913 value, is a loss sustained under the provisions of the revenue act of 1916, as amended by the revenue act of 1917?

Why the Government imagines this issue to be involved in this case is impossible for the Respondent to comprehend, because the opinion of the Court of Claims specifically refers to and strictly follows the decision of this Court on this precise question in *Goodrich* v. *Edwards*, 255 U. S. 527, and *United States* v. *Flannery*, 268 U. S. 98 (R. 17).

The Rule for which the Government is Contending has not been Acquiesced in Generally by Taxpayers.

The Government has stated as one of the reasons for the granting of the petition, that the rule for which it is contending has been acquiesced in generally by taxpayers. This is not the fact, as is evidenced by the existence of this very suit. Here the Respondent is suing to recover taxes paid on his 1917 income. The 1917 returns were filed eight years ago. The taxpayer has been diligent in the prosecution of his rights. He has not been guilty of dilatory tactics but has, on the contrary, urgent-

ly pressed his claim. The year 1917 was the first one in which very large taxes were levied, and it has taken the Respondent eight years to obtain a hearing in the Courts on this question. It is submitted it comes in poor grace from the Government to say that this rule has long been acquiesced in by taxpayers, when by its own tardiness and delay it has prevented the litigation of the question over a period of eight years.

Does counsel for the Government have prescience denied the ordinary man? How may he say the rule has generally been acquiesced in when it has been impossible for taxpayers to have the Commissioner take his position in respect of the taxpayer's liabilities until seven years or more have elapsed from the date the taxpayer's return was filed?

The Government, after having stated the rule for which it is contending has long been acquiesced in by taxpayers, states among its reasons for granting of the petition (R. 4.)

> "An ascertainment of the amount of taxes in *other cases* dependent upon the correctness of the Government's decision is not possible * * * "

Thus, the Government contradicts itself.

The Government has not uniformly followed the rule contended for.

The Petitioner states the following as a reason why this Court should grant the petition (R., 4):

> "2. The determination of the questions involved herein vitally affects the rules followed by the Internal Revenue Bureau since the inception of income taxation. The decision of the Court of Claims is antagonistic to these rules, which have been generally acquiesced in by taxpayers. A change in the rules at this time would affect all

> years previous to the effective date of the revenue act of 1924, which makes specific provision for such cases. An ascertainment of the amount of taxes in other cases dependent upon the correctness of the Government's position is not possible, but, without question, it runs into many millions of dollars.
>
> The rule followed by the Government has been approved by the Board of Tax Appeals. (Even Realty Company, I B. T. A. 355.)"

This statement, the Respondent, belives to be unsupported in fact.

Under the Revenue Act of 1917, which is the act governing the decision of this case, the Treasury Department's Regulations did not require that so-called depletion and depreciation should be deducted from the cost, i. e., added to the sales price. Under the Revenue Act of 1918, the Treasury Department's Regulations did require that *all* so-called depletion sustained in the operation of oil properties should be deducted from the cost, whether or not the amount of such depletion sustained was allowable as a deduction in computing annual net income. Under the Revenue Act of 1921, the Treasury Department's regulations were changed again, so as to require the deduction from the cost, i. e., the addition to the sales price, of only so much of the so-called depletion as had been allowed as a deduction from income. The Revenue Act of 1924 was the first statutory enactment which required the reduction of cost by the amount of so-called depletion and depreciation previously allowed as a deduction in computing annual net income.

Thus, we have it that the rule which the Government says has been effective since the inception of income taxation, was not in force at all under the 1917 Act, was put into full force under the 1918 Act, modified under the 1921 Act and was only included in the statute in the 1924 Act.

Treasury Department Regulations 33 Revised (governing the collection of the income tax imposed by the Act of September 8, 1916, as amended by the Act of Oct. 3, 1917), Article 101, provided as follows:

> "If a corporation sells its capital assets in whole or in part, it will include in its gross income for the year in which the sale was made an amount equivalent to the excess of the sales price over the fair market price or value of such assets, as of March 1, 1913, if acquired prior to that date, or over cost if acquired subsequent to that date. * * *"

Treasury Department Regulations 45 (promulgated April 16, 1919) governing the collection of the income tax imposed by the Revenue Act of 1918 provided as follows:

> "Art. 1561. For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is (a) its fair market price or value as of March 1, 1913, if acquired prior thereto, or (b), if acquired on or after that date, its cost or its approved inventory value. In both cases proper adjustment must be made for any depreciation or depletion *sustained*. * * *" (Italics ours.)

The ruling last quoted remained in effect until February 15, 1922, when Regulations 62 (governing the collection of taxes under the Revenue Act of 1921) were promulgated. The ruling was changed to read as follows:

> "Art. 1561. For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. * * * In any case proper adjustment must be made in computing gain or loss from the exchange or sale

> of property for any depreciation or depletion *sustained and allowable* as a deduction in computing net income * * *." (Italics ours.)

None of the above mentioned Revenue Acts required depletion or depreciation to be deducted from cost in determining gain or loss on a sale. However the Revenue Act of 1924 (enacted June 3, 1924) contained the following provision:

> SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.
>
> (b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property." (Italics ours.)

Thus it appears that prior to April 16, 1919, (the date of the promulgation of Reg. 45) the rulings of the Bureau of Internal Revenue *did not* require an adjustment in cost for depletion or depreciation. It further appears that the ruling in force from April 16, 1919, to February 15, 1922, required cost to be reduced by the full amount of depletion and depreciation *sustained*, even though that amount was in excess of the deduction previously allowed in determining annual net income. It also appears that the ruling in force subsequent to February 15, 1922, required cost to be reduced only by the amount of depletion and depreciation *allowable* as a deduction in computing annual net income. The first statutory requirement of an adjustment for depletion and depreciation was contained in the Revenue Act of 1924, and

that referred only to depreciation and depletion *previously allowed* as a deduction in determining annual net income.

The decision of the court below, if affirmed by this court, would only require a change in the rulings under Regulations 45 and Regulations 62, which governed the years 1918 to 1923 inclusive. The ruling under Regulations 45 admittedly was erroneous in requiring cost to be adjusted by the amount of depreciation and depletion *sustained.* The error was partially corrected in Regulations 62.

The decision of the Board of Tax Appeals in the matter of Even Realty Company had reference only to depreciation and the effect of the decision was that cost should be reduced by the amount of depreciation *allowed* as a deduction from net income. In its opinion the Board said:

> "* * * Until the manufacturer has *recovered the cost or basic value* to him of the proportionate parts of these items attributable to a unit of his product sold, he cannot properly be said to have received income upon its sale, and only the excess of the sales price realized over the sum of these items (whatever particular form they may take) is truly income. * * *" (Italics ours.)
>
> I. B. T. A. 359.

In view of the fact that in many cases the statute of limitations has barred refunds of taxes for the years prior to 1921 respondent believes that the Petitioner's statement that the affirmance of this decision will mean a loss of "many millions of dollars" to the Government is greatly exaggerated.

The Treasury Department under regulations promulgated in accordance with the Revenue Act of 1917 did not require cost to be reduced by the amount of so-called depletion or depreciation sustained in determining the gain or loss in the case of the sale of capital assets. This case arises under the Revenue Act of 1917 and under Regulations 33 (Revised) promulgated thereunder. The regulations under the Revenue Acts of 1918 and 1921 are of no relevancy in the ascertainment of taxes due under the Revenue Act of 1917. The Revenue Act of 1924 had incorporated in it a provision directing that so much of the so-called depletion or depreciation which had been allowed as a deduction, should be deducted from cost in determining the amount of gain or loss in the sale of capital assets. If this proves anything, it proves that a different rule was contemplated under the prior statutes. *U. S.* v. *Field*, 255 U. S. 257, *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602.

So-Called Depletion is an Earning which was Taxed as such by Congress, and such Taxation was Sustained by this Court, until Congress Permitted a Deduction out of the Abundance of its Powers.

The word "depletion" as used by the Government is a misnomer. "Depletion" in mining or oil properties so far as federal income taxation is concerned does not exist as such. Discovery may outrun depletion. *Stratton's Independence* v. *Howbert*, 231 U. S. 399. This Court has found that returns from mining operations are not capital returns in whole or in part, but are income, *Stratton's Independence* v. *Howbert*, *supra; Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, thus following the rule laid down by the Supreme Court of Pennsylvania in the only

reported income tax case involving the operation of oil properties. *Commonwealth v. Ocean Oil Co.*, 59 Pa. 61. This Court has held that the removal of natural deposits is merely an incident of business and that the part of the deposits removed in this process is not depletion of the capital. The mere fact that Congress, in the abundance of its powers, permits a deduction from gross income of an amount which it denominates depletion, does not change the character of the proceeds derived from the operation of oil properties.

The Respondent Sustained an Actual Loss on the Sale of the Properties.

The Government in its brief (p. 8) states:

> "The loss allowed by the Court of Claims arose out of the following transaction. On March 1, 1913, the taxpayer had a capital asset consisting of the Goodman Fee and the Matney Lease and the physical equipment thereon worth $47,500. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. By this outlay he acquired a right which the court below describes as 'a mere right to extract whatever oil he could, be that amount small or great.' During the period of his ownership, the taxpayer exercised his right and removed oil which, in the ground, had a value of $32,253.81. During the year 1917, he sold the properties for $81,400.00. The total outlay therefore was $95,-977.33 as against total receipts of $113,653.81."

It then states

> "It is plain that this *transaction* did not *cause* the taxpayer any actual loss."

What does the Government mean by "this transaction"? If it means *the sale* of the assets, we disagree

with the conclusion that the transaction did not cause an *actual loss.* If it means the purchase of the assets, the owning and operating of them and their subsequent sale (all of these elements considered as one transaction) we submit that the Government has missed the point and gone far afield.

The Court of Claims held that there was a loss sustained *on the sale* of the properties. It did not hold that the taxpayer sustained a loss in operating the properties. If A buys an automobile for $2,000 and in the following year sells it for $50 (even assuming allowance is made for wear and tear) he sustains *a loss on the sale* notwithstanding he may have made a net profit of $5,000 by *using* the car in a taxicab business.

A loss sustained from the sale or other disposition of property is an *actual* loss and is clearly recognized as such by Sec. 5 (a) Fourth of the Statute, supra. In computing such a loss it is not proper to take into account the profit made in the use or operation of the property. Using or operating property is a distinct transaction from that of selling the property. Apparently the Government refuses to recognize the distinction.

The Government seems entirely to miss the point *that every dollar received by the Respondent from the operation of these properties (after 1913) was included in the computation of Respondent's taxes at the rates and in the manner prescribed by law for the year received.*

While owned by the Respondent the Property did not Change in Character.

On page 10 of its brief the Government urges that the taxpayer has not sold the same right which he acquired and states, "This is necessarily true because in the meantime the taxpayer has used the right." Further on it is stated (page 11), "The fact that the use changed the character of the property is the material factor."

If the Government means the property has been changed in character, we deny the truth of the statement. If the Government means the property has been changed in value, we admit that such may be true, but deny its materiality. What was purchased was the fee to lands that happened to contain oil—what was sold was exactly the same thing, no more and no less; the leases when acquired gave the lessee the right to enter and to reduce to possession whatever oil might be found within the premises—the leases when disposed of, transmitted exactly the same thing, no more and no less. Because oil had been extracted between the time of acquisition and the time of disposition changes not one whit the accuracy of the foregoing statements. Extraction of oil may or may not have affected the value of the properties, but it did not change their character, and confusion of change in *character* with change in *value* is apparently at the foundation of the Government's difficulty.

Lynch v. *Alworth Stephens Co.*, 267 U. S. 364, cited on page 12 of the Government's brief, held that the interest of a lessee of iron mining properties *lessened* from year to year. There is no change in the *character* of the fee owner's right as a result of the operation of the property and the extraction of oil.

The Decision of Court of Claims does not Permit a Double Deduction.

On page 12 of its brief the Government contends that "the effect of the decision of the Court of Claims is to permit a deduction from the sale price of an amount previously deducted by way of depreciation and depletion from capital investment in prior years."

The effect of the decision on the contrary is to prevent the Bureau of Internal Revenue from denying to the taxpayer *the deduction allowed by Congress for de-*

preciation and depletion. The Commissioner requires the taxpayer in determining gain or loss on the sale of a capital asset to reduce the cost of that asset by the amount of the depletion deduction allowed by Congress. In other words the Commissioner allows the annual deduction granted by Congress for depletion, *provided* the asset is not sold. If the asset is sold the Commissioner deprives the taxpayer of this deduction by increasing his profit or decreasing his loss by the amount previously allowed for depletion.

Doyle v. *Mitchell Bros. Co.*, 247 U. S. 179, cited on page 13 of the Government's brief arose under the corporation excise tax of 1909 and was strictly limited by the Court to the peculiar facts in that case.

In *Stratton's Independence* v. *Howbert, supra, Stanton* v. *Baltic Mining Company, supra, Von Baumbach* v. *Sargent Land Company*, 242 U. S. 503, *United States* v. *Biwabik Mining Company*, 247 U. S. 116, and *Goldfields Consolidated Mines* v. *Scott*, 247 U. S. 126, this Court held that the proceeds from mining operations did not include a return of capital, and in *Doyle* v. *Mitchell Brothers, supra,* this Court said (p. 188):

> "There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act."

Congress *was not* required to make an allowance for depletion in computing taxable net income. It saw fit to do so, however, by granting a deduction in computing annual net income.

On the other hand, Congress *was* required, in computing gain on a sale of capital assets to make allowance

for the original capital investment and to distinguish that capital from the income subjected to tax. On page 185 of this Court's opinion in the *Doyle* v. *Mitchell Brothers* case, *supra*, this statement is made with reference to the term "income":

> "Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income'. *In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.*" (Italics ours.)

COST REPRESENTS CAPITAL. DEPLETION IS NOT A RETURN OF CAPITAL.

CONCLUSION.

The decision of the Court of Claims is consistent with the decisions of this Court and in no way conflicts with the decisions of other courts.

It conforms to established legal principles.

The Court of Claims gave careful and thorough consideration to the case and rendered an unanimous decision.

Respectfully submitted,

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